United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-1309

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P/S

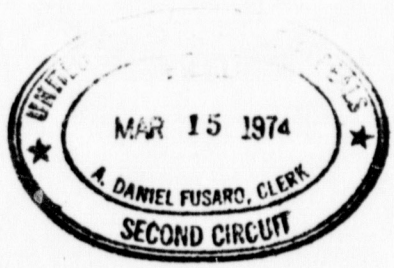
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- x

In the Matter of	:	In Proceedings for an Arrangement No. 73 B 1208
UNISHOPS, INC.,	:	
Debtor.	:	Docket No. 74-1309

- x

BRIEF OF APPELLEE
MANOW INTERNATIONAL CORP.



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PRELIMINARY STATEMENT

This brief is submitted on behalf of Manow International Corp. (hereinafter "Manow"), a New York corporation. Manow is a creditor of Perry's Shoes, Inc. (hereinafter "Perry's"), a subsidiary of Unishops, Inc. (hereinafter "Unishops"), the debtor in possession and appellant in this proceeding. This brief is submitted in support of District Court Judge Brieant's Memorandum and Order of March 4, 1974 which affirmed Bankruptcy Judge Babitt's Order dated February 6, 1974 denying the application of the debtor in possession for an order restraining and enjoining creditors of Unishops' subsidiaries from instituting any action or proceeding against any such subsidiary, except in the bankruptcy court.

STATEMENT OF FACTS

In conformity with Judge Babitt's Order of February 6, 1974 and Judge Brieant's Order of March 4, 1974, we must assume for the purposes of this appeal that the facts set forth in the appellant's original Application dated December 12, 1973 are true. The numerous answers denying the factual allegations contained in appellant's Application were not made a part of the record on appeal for this proceeding (see the Minutes of the hearing of February 6, 1974).

Judge Brieant's Order and Memorandum does, however, advert to the fact that lawsuits based upon purchase orders placed by Unishops' subsidiaries prior to June 1, 1973 have been effectively restrained thus far in these bankruptcy proceedings, see Memorandum per Brieant, J. at page 6. In order to verify Judge Brieant's Memorandum in this regard and to provide essential background to Argument II, infra, Manow respectfully submits to this court the following facts: (1) Manow's cause of action for $15,840.00 is based upon a Perry's purchase order (no other name besides Perry's appears on said order) dated March 22, 1973 calling for the fabrication, tieing and tagging of 7,200 pairs of shoes, and

their delivery to Perry's at 355 Gotham Parkway, Carlstadt, New Jersey between August 1 and August 10, 1973; (2) Manow delivered said shoes on or about August 9, 1973 and received a check for $108.00 drawn by Perry's to cover the cost of tieing and tagging said shoes on or about October 11, 1973; (3) Manow never received the alleged notification letter of June 1, 1973 (the letter was not seen until notice of Unishops Chapter XI proceedings was received), nor did Manow ever agree orally or in writing that Unishops would be substituted as the contracting party for Perry's on the aforementioned Perry's purchase order; (4) Manow has repeatedly demanded payment from Perry's for the $15,840.00 due for goods sold and delivered and Perry's has refused and continues to refuse to pay this sum to Manow; (5) Manow believes that Perry's is solvent.

Although it would serve no useful purpose to restate all of the facts contained in appellant's Application of December 12, 1973, one point should be noted. The letter of June 1, 1973 from Unishops (attached as an exhibit to Unishops' Application) which was allegedly sent to all of the vendors of merchandise who sold to the subsidiaries contains this statement:

> "Please be advised that pursuant to the new agreement [with the banks] all orders now in your possession or hereafter given to you shall be considered given by the parent corporation, Unishops, Inc., and the parent corporation hereby assumes liability for the payment of all invoices." (emphasis added)

This statement and its full legal implications are discussed in Judge Brieant's Memorandum and Argument II, infra.

Based upon appellant's ex parte application of December 12, 1973, and pursuant to 11 U.S.C.A. §711 and §714, Judge Babitt entered an Order to Show Cause and a temporary restraining order against any suits brought by creditors of appellant's subsidiaries on December 13, 1973. A hearing on said temporary restraining order was apparently held, without notice to appellee, on December 27, 1973, whereupon it was adjourned, with temporary stay continued, to January 7, 1974. On January 7, 1974, a hearing was apparently held, again without notice to appellee, in which appellant applied for an adjournment, with temporary stay continued, in order to prepare for an evidentiary hearing on the merits of its Application. The case was adjourned until February 6, 1974, at which time Judge Babitt, after listening to oral arguments from appellant and a few of the numerous appellees present in court, reversed his temporary restraining order of December

13, 1973 on the ground that he lacked jurisdiction to restrain all suits of all creditors of appellant's subsidiaries. Judge Babitt did, however, stay execution of his February 6, 1974 Order until an appeal could be heard by the District Court. Judge Brieant heard the argument on appeal on February 28, 1974 and on March 4, 1974 he affirmed Judge Babitt's Order of February 6, 1974 in all respects, continuing the stay until an appeal could be heard by this court.

QUESTIONS PRESENTED

1. Whether the District Judge erred in deciding that no evidentiary hearing was necessary, and that even under the facts as alleged in appellant's Application, the court did not have jurisdiction to restrain suits brought by creditors of the appellant's subsidiaries against those subsidiaries?

2. If this court decides that an evidentiary hearing is necessary, does the bankruptcy court, as a matter of law, have jurisdiction to restrain suits based upon transactions entered into between appellant's subsidiaries and their creditors prior to June 1, 1973, the date when appellant first changed its buying practices and allegedly notified the industry?

POINT I

THE DISTRICT JUDGE DID NOT ERR IN DECIDING THAT NO EVIDENTIARY HEARING WAS NECESSARY FOR HIS FINDING THAT THE COURT DID NOT HAVE JURISDICTION TO RESTRAIN SUITS BROUGHT BY CREDITORS OF THE APPELLANT'S SUBSIDIARIES AGAINST THOSE SUBSIDIARIES

Judge Brieant's Memorandum and Order of March 4, 1974, was based on several considerations. First, the general rule followed in this Circuit, as enunciated in the cases of In Re Gobel, Inc., 80 F. 2d 849 (2d Cir., 1936), In Re Beck Industries, 479 F. 2d 410 (2d Cir., 1973), cert. denied, 414 U.S. 858 (1973), is that the bankruptcy court does not have power under either 11 U.S.C.A. §511 and §516(4) or 11 U.S.C.A. §711 and §714 to enjoin suits by creditors against solvent, independently run subsidiaries of the debtor in question. The rationale for the restriction on these powers has been that the debtor's property is limited to the stock of the subsidiary, rather than the subsidiary's assets, and hence, if the creditor of the subsidiary did not impress any lien upon that stock, theoretically the debtor's property remained unencumbered despite the practical loss in value of the stock, In Re Gobel, Inc., supra at 852.

At the bankruptcy hearing of February 6, 1974, Judge Babitt repeatedly requested the appellant to come forward with some precedent in support of appellant's position which would obviate the application of the general rule of Gobel and Beck. Appellant could not do so. The reason why appellant was unable to come forward with such a precedent is that cases where bankruptcy courts have pierced the corporate veil have invariably involved corporations which were created and operated as shams, e.g. Hamilton Ridge Lumber Sales Corp. v. Wilson, 25 F. 2d 592 (4th Cir., 1928), cited by In Re Beck Industries, supra, at 419 (note 10). As the court stated in Maule Industries, Inc. v. L.M. Gerstel, 232 F. 2d 294, 297 (5th Cir., 1956):

> "... the petition and the proof must show that the corporation whose property is sought to be brought into the bankruptcy proceeding was organized and used to hinder, delay or defraud the creditors of the bankrupt, and constitutes mere 'legal paraphernalia' observing form only and not existing in substance or reality as a separate entity." (emphasis added)

Appellant is perfectly aware that its numerous subsidiaries were initially organized for purposes of conducting business in their own name and on their own behalf and that they have never been used for the purposes described

by the Maule case, supra. Even after the alleged change in practices occurring on June 1, 1973, appellant's Application does not contain facts which indicate that its subsidiaries are sham corporations.

It must be noted that appellant does not allege that its subsidiaries' names do not appear on contracts or other obligations arising before or after June 1, 1973, but only that after that date, appellant itself bought all of the merchandise for its subsidiaries in its own name (see Application, page two, points four and five). Judge Babitt and Judge Brieant took cognizance of this point when they rendered their decisions. They found that if the creditors of the subsidiaries were completely misguided in their notion that they were holding obligations of the subsidiaries rather than obligations of appellant, it should be a relatively simple matter for any state court to determine that the creditor had instituted an action against the wrong party. In effect, they both found that appellant's factual allegations were not sufficient to establish that its subsidiaries were mere shams and that the appellant was the only party to obligations held by the numerous creditors of the subsidiaries.

Given the factual deficiencies of appellant's Application and the clear precedent in this Circuit set forth in the Gobel and Beck cases, supra, Judge Brieant's Order and Memorandum affirming Judge Babitt's Order was entirely correct.

POINT II

IF THIS COURT DECIDES THAT AN EVIDENTIARY HEARING IS NECESSARY, THE BANKRUPTCY COURT STILL DOES NOT HAVE JURISDICTION TO RESTRAIN SUITS BASED UPON TRANSACTIONS ENTERED INTO BETWEEN APPELLANT'S SUBSIDIARIES AND THEIR CREDITORS PRIOR TO JUNE 1, 1973.

In Re Beck Industries, Inc., supra, at 419 (note 11), indicates that the bankruptcy court must consider its jurisdiction and power to enjoin suits in other courts with respect to each individual creditor of the debtor in question. For example, in the Beck case, the only creditor that the court would even consider enjoining from bringing suit was the creditor that had full knowledge of the corporate purpose and function of the subsidiary created for the purpose of the non-taxable merger. In the instant case, it is important to point out that if an evidentiary hearing is ordered, along

with a restraining order against all suits until that hearing and all of its appeals are completed, the court may very well have restrained some creditors of the subsidiaries over whom the court has no jurisdiction, not even under the facts as contained in appellant's Application.

It seems clear from appellant's Application that June 1, 1973 was the first time that it allegedly notified the industry that it was assuming all of the current obligations of its subsidiaries and would thereafter buy all merchandise in its own name. It must be conceded, therefore, that prior to that date, not even appellant could contend that Unishops had ordered goods in its own name or that its subsidiaries had ever been sham corporations operating as its alter egos. Yet the effect of continuing any restraining order (pending an evidentiary hearing) against creditors whose claims are based upon transactions arising prior to June 1, 1973 is to acknowledge the possibility that even before any notice was given to any creditor, appellant's subsidiaries were mere sham corporations. Not even the dicta in the Beck or Gobel cases, supra, could countenance piercing the corporate veil with regard to creditors without notice, see

also, Johns-Manville Sales Corp. v. Stone, 5 A.D. 2d 110, 169 NYS 2d 259, 264 (1st Dept., 1957).

As Judge Brieant noted in his Memorandum at page 6, the letter could merely add a guarantor to a then existing contractual obligation of a subsidiary. When the obligation became fully due, e.g. by the vendor's delivery of the goods in question, the subsidiary, as an original contracting party, remained liable for the performance. To hold otherwise would acknowledge a right to a unilateral novation in violation of U.C.C. §2-210(1) and the voluminous case law prior to its enactment which simply do not allow a party to a contract to escape liability by means of an assignment.

In sum, even if the court finds it necessary to remand this case for an evidentiary hearing, it should not restrain suits by creditors based upon transactions entered into by appellant's subsidiaries prior to June 1, 1973.

The Bankruptcy Court has jurisdiction only over the debtor's property, and prior to June 1, 1973, it is not even alleged that the property of the subsidiaries was that of the appellant. Without any factual allegation or the hint of any notice to a creditor who entered into a

contract prior to that date, it is inequitable to restrain any such creditor from pursuing its lawful remedies.

Respectfully submitted,

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Of Counsel

C 321—Affirmation of Service by Mail.
Affidavit of Service by Mail on Reverse Side.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In the Matter of

UNISHOPS, INC., Debtor

~~Plaintiff~~

~~against~~

~~Defendant~~

~~Index No.~~
In Proceedings for an
Arrangement No. 73 B 1208
Docket No. 74-1309

ATTORNEY'S AFFIRMATION OF SERVICE BY MAIL

STATE OF NEW YORK, COUNTY OF NEW YORK *ss.:*

The undersigned, attorney at law of the State of New York affirms: that deponent is

associated with HESS SEGALL POPKIN GUTERMAN PELZ & STEINER *attorney(s) of record for*

MANOW INTERNATIONAL CORP. , APPELLEE

That on the 15th *day of* March 1974 *deponent served the annexed*

Brief of Appellee Manow International Corp.

on LEVIN & WEINTRAUB

attorney(s) for UNISHOPS, INC., debtor and appellant

in this action at 225 Broadway New York, New York 10007

the address designated by said attorney(s) for that purpose by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in — ~~a post office~~ — official depository under the exclusive care and custody of the United States post office department within the State of New York.

The undersigned affirms the foregoing statement to be true under the penalties of perjury.

Dated this 15th *day of* March 1974

Lowell A. Margolin

The name signed must be printed beneath

LOWELL A. MARGOLIN
Attorney at Law